

## Expanding the reach of the EU budget via financial instruments

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*This commentary, which serves as a companion piece to a larger [study](#) commissioned by the EP on this topic, aims to shed some light on the role of and rationale behind the increasing use of financial instruments in the EU budget.*

For some time now, the 2014-2020 Multi-annual Financial Framework (MFF) has been at the centre of a strong debate in EU policy circles. Besides Brexit and the consequent financial shortfall, the role of public debt and equity instruments, i.e. financial instruments (FIs), in the EU budget (and more generally in the EU economy) has been a main topic in this debate. According to [Financial Regulation \(No 966/2012\)](#), FIs are “measures of financial support provided on a complementary basis from the budget in order to address one or more specific policy objectives of the Union”.

Aside from the formal definition, what is the ultimate purpose and benefit of using these instruments, and how great a contribution can they realistically be expected to make?

Financial instruments are not an innovation. Not only have they featured for several years now in the EU budget, but debt (concessional loans and guarantees) and equity-based FIs have also played a significant role in investment support schemes of national governments through National Promotional Banks and Institutions (NPBIs) and international financial institutions (IFIs). The national and international experience has shown that FIs can contribute effectively to promote investment in areas of public interest and high public-good value.

Indeed, FIs have four appealing characteristics for policy-makers:

- ✓ *FIs enhance the sustainability of public investment* as the capital allocated to FI-based support schemes can be re-cycled for future use (as opposed to the one-off nature of non-repayable grants).

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- ✓ *FIs are designed to leverage private funds* and ensure private involvement in public investments. Accordingly, their use increases the capital available for policy purposes.
- ✓ *FIs allow incorporating private-sector skills and expertise* in areas such as project selection, decision-making, management of commercial operations and the ability to achieve commercial returns.
- ✓ *FIs ensure greater commitment by project promoters* to the quality and credibility of investment plans, by sharing the risks involved.

In practice, FIs are used in public investment policy to support profitable investments that serve public objectives. In particular, they are deployed for return-bearing projects, where the envisaged returns are not sufficient to attract private investors.

When economically profitable projects are not financed by the private sector, these gaps may be caused by market failures. *The distance between what should be financed in a market without imperfections and the reality is called a “market” or “financing” gap. Financial instruments are designed and employed to help close this gap.*

The reasons behind such a gap mainly relate to the level of risk and the maturity of the project. A financing gap may also emerge when a project creates positive externalities, such as environmental benefits, which are not private and cannot be monetised. These characteristics make such investments less appealing to private actors.

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The unwillingness of the private sector to finance a project, however, may be unrelated to the quality and profitability of the project. *A profitable project may fail to attract investments when confidence in the overall performance of the economy is low.* Economic downturns may affect investors' perceptions regarding demand risk and in turn determine a lower level of private investment. This is the reason why Public Private Partnerships (PPPs) usually incorporate demand risk. For infrastructure PPPs based on a concession, the demand risks are usually covered by the state (e.g. lower usage rate of a motorway and lower revenues from tolls).

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In addition, profitable projects may face financing constraints when the capital and the credit markets are not functioning properly. On the one hand, where capital markets are underdeveloped, the cost of capital is too high for small and medium-sized enterprises (SMEs). On the other hand, when the profitability of the banking system is low, credit institutions may be reluctant to lend to SMEs. Indeed, even in case of economically sound investments, the costs

associated with the project's probability of default and monitoring activities may be higher than the profits that the project may generate.

*This means that the 'market failure' is not always evident or present. The same project may or may not need support depending on the specific circumstances at any given time. Therefore, the oft-repeated statement that the purpose of financial instruments is to finance risky projects is partial and misleading. Financial instruments are created to stabilise investments in areas of public interest. By leveraging private funds in bankable projects, FIs contribute to unlocking investment in projects in which the private sector is unwilling to invest by itself.*

The level of risk may or may not be a key component. If an investment has a sound profile, it may not attract financing because it competes with others that offer quicker or higher rewards. This is important to keep in mind, because even *in times of economic boom with high-return options, financial instruments may still be useful to support important but less-profitable investments, which in other circumstances would be financed privately.*

*It follows that the areas of deployment and the amount available for investment support schemes using FIs need to be reviewed at regular intervals and adapted to market circumstances.* The larger the market gap, the greater should be the public support through FIs. This would function as a buffer during periods when private investment decreases. Conversely, the smaller the financing gap, the lower should be the amount allocated to FIs support schemes. This should ensure that public funds are not competing and crowding out private financing or funding unprofitable projects.

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One note of warning, however, is that *financial instruments are no substitute for good governance and structural reforms*. When the private sector does not invest because the economy is sluggish due to structural issues, national and local governments should address the root causes rather than creating financial instruments to circumvent the problem. Attempting to fight policy distortions with other distortions is a risky strategy.

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In sum, FIs in public investment support schemes are a means to mobilise private finance for projects with high public-good value added in times when the private sector seems unwilling to finance them on its own. For the future, the question is not if FIs are needed, but how do we ensure that they are flexible enough to react to market needs, improve allocative efficiency in the economy and crowd in rather than crowd out the private sector. For FIs, it is the quality rather than the size of the pie that matters.



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